B. DEVELOPMENTS IN UNRELATED BUSINESS TAXABLE INCOME

1. Introduction

The past year has seen a number of very significant developments in the area of unrelated business taxable income under IRC 511-513. Judicial decisions top the list of significant developments, including two Supreme Court decisions, both decided in the past term. For an unrelated business income case to reach the Supreme Court is somewhat unusual. For two unrelated business income cases to be decided by the Supreme Court during the same term with a strong majority of justices voting in favor of the Government's position is quite extraordinary. This topic will focus on both cases, American Bar Endowment, and American College of Physicians, each of which has been the subject of previous CPE articles, most recently in 1986 and 1985, respectively.

Other recent court decisions will also be discussed, as lower courts continue to grapple with various issues under IRC 511-513, and cases make their way through the Federal court system. Also on the horizon are possible Congressional hearings on unrelated business income, the prospects of which are becoming more likely.

2. American Bar Endowment

A. The Organization

The American Bar Endowment (ABE) is a charitable organization exempt under IRC 501(c)(3). Its charitable purposes include promoting legal research and education in order to advance the administration of justice and the science of jurisprudence. These purposes are accomplished by making grants to support projects undertaken by the American Bar Foundation (exempt under IRC 501(c)(3)), the research arm of the American Bar Association (ABA) (exempt under IRC 501(c)(6)). All members of the ABA are automatically members of ABE. ABE was established in 1942, and its members were encouraged to contribute to it through gifts and bequests. By the early 1950's, however, individual donations were sporadic, and a fundraising plan was proposed based on the sale of group life insurance. Beginning in 1955, ABE raised funds for its grant-making program by sponsoring and administering group insurance policies.

ABE is the group policyholder and administrator of insurance policies offering substantial amounts of life, disability, in-hospital indemnity, excess major medical, and accidental death and dismemberment coverage. ABE negotiates premium rates with insurers and chooses which insurers will provide coverage. It also compiles a list of its own members, solicits their insurance business, collects premiums paid by members, transmits the premiums to the insurer, maintains files on each policyholder, answers members' questions concerning insurance policies, and screens claims for benefits. Only members in good standing are eligible to purchase coverage under these policies. Approximately 20 percent of ABE's members participate in the group insurance program.

Purchasing insurance on a group basis is preferable to purchasing as an individual because in the case of ABE, its size gives it bargaining power that individuals lack, and because the group policy is "experience-rated." Experience-rating relates to the cost of insurance being based on the group's claims experience rather than general actuarial standards. Under the terms of the insurance contracts negotiated by ABE with insurance companies, the amount of premiums not needed by the insurer to pay claims and administrative expenses is refunded to ABE as a "dividend," or "experience rating credit." From these amounts, ABE pays its own administrative and promotional expenses and uses the balance to fund its charitable grant-making program.

As part of the contract between ABE and the insured members, individual insureds are required to sign a statement acknowledging that all dividends will be paid to and used by ABE to further its charitable and educational activities. Individual insureds could not obtain the portion of the dividend allocable to their premium payments. However, they were annually advised by ABE that, in the opinion of its counsel, they could claim a charitable contribution deduction for this amount. Four individuals who claimed this deduction under IRC 170 and had it denied by IRS, had their cases joined with the ABE litigation under IRC 511-513.

ABE could negotiate lower premium rates for its members than the rates charged, but this would result in a lower dividend being available to ABE. The rates charged are designed to be competitive with other insurance policies offered to the public and ABE members. In recent years the total amount of dividends exceeded 40 percent of members' premium payments. The excellent experience rating in terms of mortality and morbidity for ABE member-insureds results in a combination of low claims, high dividend refunds, and competitive premium rates.

Administratively, the Service advised ABE that it considered ABE's insurance plan unrelated trade or business under IRC 511-513, and that amounts derived from such activity were subject to tax. A tax deficiency was assessed by the Service. ABE paid the taxes, exhausted its administrative remedies, and brought an action for a refund in the Claims Court, arguing that revenues from the insurance program were not subject to tax. At approximately the same time, the four individuals, who were participants in the insurance program, brought suit for refunds in the Claims Court as well. The individuals argued that they were entitled to charitable deductions for a portion of their premium payments. The two suits were consolidated for trial in the Claims Court.

B. The Lower Court Decision

In American Bar Endowment v. U.S., 4 Cl. Ct. 404 (1984), the Claims Court held for ABE on the unrelated business income issue, but for the Government on the charitable contribution question. On the question of whether the insurance activity is a trade or business (the crux of the UBI issue), the Court used a "competitive, commercial manner" standard from Disabled American Veterans v. United States, 650 F.2d 1178, 227 Ct. Cl. 474 (1981) (DAV). This standard was used rather than the standard of profitability or maximization of revenue advanced by the Government. The Court indicated that determining whether income was derived from the provision of goods or services, as distinguished from fund-raising, depended on whether the activity was conducted in a competitive, commercial manner. The Court determined ABE's insurance program was not operated in this manner because (1) the history of the program indicated it was originally conceived as a fund-raising mechanism; (2) the leadership and the membership generally viewed it as a fund-raising activity; (3) "staggering" profits were generated; (4) ABE informed its members and the public of the amount raised through the insurance program; and, (5) the program was operated with the approval and consent of the membership.

According to the Claims Court, cases such as Professional Insurance Agents of Michigan v. Commissioner, 726 F.2d 1097 (6th Cir. 1984), Carolinas Farm & Power Equipment Dealers Ass'n. v. United States, 699 F.2d 167 (4th Cir. 1983), and Louisiana Credit Union League v. United States, 693 F.2d 525 (5th Cir. 1982) were not on point. The Government cited these cases for the proposition that operation or sponsorship of insurance programs by tax-exempt organizations constitutes unrelated trade or business. The Claims Court stated that the "profit motive" standard used in these cases with respect to business leagues exempt under

IRC 501(c)(6) was not appropriate with respect to charitable organizations exempt under IRC 501(c)(3). Also, the cases were said to be factually distinguishable.

On the contributions issue, the Court stated that the four individuals could establish their insurance premium payments were of a dual nature, part purchase price/part charitable contribution, only if they "bought goods or services for more than their economic value, with the intention that the excess be used to benefit a charitable enterprise." Applying this analysis, the Court held that three of the individuals failed to carry their burden of showing they paid more for ABE coverage than they would have otherwise had to pay. The fourth individual proved that he was eligible to purchase less expensive comparable insurance; however, he was still not entitled to a deduction because he did not prove he had knowingly passed up this more attractive insurance in order to make a contribution to ABE.

C. The Appellate Court Decision

In American Bar Endowment v. U.S., 761 F.2d 1573 (Fed. Cir. 1985), the United States Court of Appeals for the Federal Circuit affirmed the Claims Court's judgment for ABE, but reversed and remanded the cases of the four individual insureds. The Court recited the three part test for unrelated business income, whereby ABE's insurance program would be taxable if it (1) constitutes a trade or business; (2) is regularly carried on; and (3) is not substantially related to ABE's exempt purpose or function. ABE had conceded that it did not meet parts (2) and (3), and, therefore, only part (1) of the test -- whether ABE carries on a trade or business by conducting the insurance plan -- was at issue. On the unrelated business income issue, the Court affirmed on the basis of the Claims Court's opinion, stating that the trial court applied the correct standard for determining trade or business (DAV's "competitive, commercial manner" standard), and properly applied that standard to the facts of the case. The IRC 501(c)(6) cases were distinguished, not only for the reasons stated by the trial court, but also because ABE's compensation was received in the form of dividends assigned by the members rather than stipends paid by the insurance companies. In addition, the Court further distinguished these cases by stating that services performed by the business leagues cited above were in competition with commercial enterprises. It was concluded that ABE's funds were not received as the result of a commercial exchange and, therefore, did not constitute profits from a trade or business.

In reversing the judgment against the four individuals, the Court of Appeals rejected the trial court's legal standard. The Appellate Court felt that the individual insureds could make out a prima facie case in support of their claim to a charitable

deduction by swearing they purchased coverage from ABE in order to aid it in its charitable endeavors. The burden would then shift to the Government to show that the transaction was "basically business oriented." The Court remanded for further proceedings consistent with this analysis. The Government petitioned the Supreme Court for certiorari on both the unrelated business income and the deductibility of contributions issues. The Supreme Court granted cert.

D. The Supreme Court Decision

On June 23, 1986, in a 6 to 1 decision the Supreme Court held that ABE's insurance program constitutes both the sale of goods and the performance of services, and therefore is a trade or business for purposes of the tax on unrelated business income. The Court also held that the individual taxpayers had not established that any portion of their premium payments is a charitable contribution. See United States v. American Bar Endowment, 106 S. Ct. 2426 (1986). Justices Powell and O'Connor took no part in the consideration of the case or the decision. Speaking for the Court, Justice Marshall noted that assembling a group of better than average insurance risks, negotiating on their behalf with insurance companies, and administering a group policy are activities that are provided by private commercial entities in order to make a profit. The Supreme Court's opinion sets forth a critique of the Claims Court's analysis, which it found to be deficient in a number of respects.

First, the Supreme Court stated that it could not agree with the Claims Court that the enormous dividends generated by ABE's insurance program cannot constitute "profits." Since there is no factual basis for concluding that members' generosity is the reason for ABE's success, the Supreme Court characterized the situation as "a standard example of monopoly pricing."

Second, the Supreme Court found the argument that ABE's members could change the insurance program through their control of the organization and receive the bulk of the dividends themselves to be unconvincing. The crucial fact is that an ABE member does not have a choice between retaining his or her pro-rata share of dividends or assigning them to ABE. Rather, members are required to assign to ABE all dividends as a condition for participating in the insurance program. The Court found the members' theoretical ability to change the program to be inconclusive.

Third, the Supreme Court stated that the Claims Court erred in concluding that ABE's insurance program did not present the potential for unfair competition. The Court struck at the heart of the matter by stating the following:

> "This case presents an example of precisely the sort of unfair competition that Congress intended to prevent."

Fourth, the Supreme Court found that the only possible argument in ABE's favor is that the insurance program is a fund-raising effort. However, as stated in the opinion, that fact, standing alone, cannot be determinative, otherwise any exempt organization could engage in a tax-exempt business by "giving away" its product in return for a contribution equal to the market value of the product.

The opinion contains a footnote in which the Supreme Court briefly addressed the Claims Court's attempt to distinguish the previously cited IRC 501(c)(6) cases involving the sale of insurance. The Supreme Court stated that the Claims Court's distinction between IRC 501(c)(6) business leagues and IRC 501(c)(3) charities is "insubstantial."

The Court also addressed the question of the deductibility of charitable contributions by the four individual taxpayers, and noted that the Claims Court applied the proper standard whereby a payment is deductible only if and to the extent it exceeds the market value of the benefit received, and the excess payment must be made with the intention of making a gift. The Court of Appeals' "basically business oriented" test was rejected, and it was held that none of the four individuals had established that any portion of their premium payments constitutes a charitable contribution.

E. Postscript

Because the Supreme Court decision in United States v. American Bar Endowment is relatively recent, its impact has yet to be felt. However, two conclusions are readily apparent: first, the decision represents a clear and decisive victory for the Government in the area of insurance activities as unrelated trade or business, and second, the decision will be an important precedent in this area.

As this article was being prepared, the Court of Appeals for the Seventh Circuit cited United States v. American Bar Endowment in holding that premiums received by a business league exempt under IRC 501(c)(6) in connection with an errors and omissions program (professional malpractice insurance) constitute

unrelated business taxable income. The Court concluded that these insurance activities did not contribute to improving conditions in the industry in general, and were not substantially related to any of the organization's exempt purposes. Of importance was the fact that insurance coverage was available from other sources. The Court also stated that the insurance activities were carried on for the production of income and constituted a "trade or business" for purposes of the tax on unrelated business income. See Illinois Association of Professional Insurance Agents, Inc. v. Commissioner, (7th Cir. Sept. 25, 1986).

Undoubtedly, the Supreme Court decision in United States v. American Bar Endowment will be cited in many future cases.

3. American College of Physicians

A. The Organization

The American College of Physicians is an organization recognized as exempt under IRC 501(c)(3). Its purposes include upholding and maintaining high standards in medical education, medical practice, and medical research; encouraging research, especially in clinical medicine; and fostering measures for the prevention of disease and for the improvement of public health. Membership in the organization is limited to members of the medical profession engaged in practice, teaching, research, or other pursuits in the field of internal medicine or in allied or related specialties.

In furtherance of these purposes, the organization publishes a journal called Annals of Internal Medicine. The journal contains scholarly articles relevant to the practice of internal medicine, advertisements of medical products, supplies, and equipment useful in the practice of internal medicine, and notices of positions desired or available in connection with the practice of internal medicine. The organization's members receive the journal as a benefit of membership while nonmembers may acquire the journal by subscription or per issue. Advertisements in the journal are "stacked" in two sections -- at the front of and behind the editorial content of each issue. Advertisements in medical journals published by commercial organizations are generally also grouped in stacks rather than dispersed throughout an issue. Advertisements were prepared by the advertisers and not by the organization. Advertising space was made available in the journal at rates competitive with those charged by commercial organizations for advertising space in their medical journals. The organization's policy is to accept only those advertisements relating to medical products (primarily drugs), supplies, and

equipment useful in the practice of internal medicine. Proferred advertisements are screened for accuracy and relevance to internal medicine.

In the 1975 tax year, gross advertising income attributable to the journal was $1,376,322. Direct advertising costs were $833,050. Circulation income and readership costs attributable to the journal were $1,057,754 and $1,351,167, respectively. Another of the organization's publications produced a loss of $96,471. The organization reported taxable income of $153,388 and paid federal income taxes of $55,965 for the 1975 tax year. The organization timely filed a claim for a refund of those taxes on the basis that the advertising was related to the journal's exempt purposes, and subsequently filed a suit for a refund of the taxes in the United States Claims Court.

B. The Lower Court Decision

In American College of Physicians v. United States, 3 Cl. Ct. 531, 52 AFTR 2d 83-6176 (1983), the Claims Court held that the organization was not entitled to a refund on taxes paid in connection with its advertising income. The Claims Court found the advertisements to be unrelated to the organization's exempt purpose or function. The trial judge found that many of the ads appearing in the journal were identical to those appearing in medical journals published by non-exempt organizations. He also found that the journal's advertising business was operated in material respects like the advertising business of any other publication. The Court noted that the manner in which the advertising activity was conducted did not support the organization's assertion that the advertising contributed importantly to the education of its members because the ads did not attempt to present a comprehensive survey of the products and were repeated month after month; and some ads bore no conceivable relationship to the organization's exempt purposes. The Court concluded:

> "To avoid the [unrelated business income tax,] an exempt organization would have to run its advertising business much differently than did plaintiff. For example, it might make a concerted effort to provide advertising that comprehensively surveys a particular field, includes all recent developments in that field, or otherwise makes a systematic presentation on some subject relevant to the organization's exempt purpose. To qualify for exemption, the advertising package as a whole must serve an identifiable educational objective that goes substantially beyond the information content of the individual advertisements. This standard is not met where, as here, the

comprehensiveness and content of the advertising package is entirely dependent on each manufacturer's willingness to pay for space and the imagination of its advertising agency."

The Court also found the advertising did not escape tax under the exception provided by IRC 513(a)(2) because the advertising was not an activity carried on primarily for the convenience of the members. The organization appealed the Claims Court decision to the Court of Appeals for the Federal Circuit.

C. The Appellate Court Decision

In United States v. American College of Physicians, 743 F.2d 1570, 54 AFTR 2d 84-5941 (Fed. Cir. 1984), the Appeals Court reversed the Claims Court, holding that the trial court's finding as to relatedness was clearly erroneous.

In arriving at its decision, the Appeals Court construed the legislative history of IRC 513(c) to the effect that, in its view, Congress amended the statute only to provide that advertising activity shall be treated as a separate trade or business for purposes of analysis. The Court's statutory construction rests on the belief that Congress made no change in the "substantially related" and "convenience" tests of IRC 513(a), and that Congress did not intend to tax all advertising revenue of all journals of exempt organizations; and even if it did so intend, the statute does not contain appropriate language in furtherance of such intent.

The Appeals Court was critical of the trial court's imposition of a more strict standard than that required by the statute. In its view, the absence of a comprehensive presentation of advertisements was not fatal with respect to meeting the relatedness test. The Appeals Court stated that the trial court was ". . . apparently distracted by the commercial character of the advertisements and failed to focus properly on the substantiality of the relation of the information content of the advertisements to the [organization's] educational function." The Appeals Court concluded that the advertisements contribute importantly to the organization's exempt purpose and that the sales of advertising in the journal are substantially related to the organization's exempt purpose to educate internists, and, therefore, are not taxable under IRC 511. The Government petitioned the Supreme Court for certiorari, and the petition was granted.

D. The Supreme Court Decision

On April 22, 1986, in a unanimous decision, the Supreme Court reversed the Court of Appeals for the Federal Circuit and held that advertising in the journal of the American College of Physicians does not contribute importantly to the organization's exempt educational purposes, and, therefore, is subject to tax under IRC 511-513. See United States v. American College of Physicians, 106 S. Ct. 1591 (1986).

Although the Supreme Court ultimately held that the organization's advertising was not substantially related to its exempt purpose or function, it did address and reject another argument advanced by the Government. According to the Government, Congress and the Treasury established a blanket, per se rule whereby advertising published by tax-exempt professional journals can never be substantially related to the purpose of those journals. This position was based on the enactment of IRC 513(c) as part of the Tax Reform Act of 1969, the legislative history accompanying the statute, and Example 7 of Reg. 1.513-1(d)(4)(iv). (The Code, regulations, and legislative history pertaining to this issue are set forth in the 1985 CPE text.)

Despite this contention, the Court found that the regulations do not create a blanket rule of taxability, and that Congress and the Treasury did not intend to set out a per se statement of law. The Court noted the general case-by-case analysis that occurs in the area of unrelated business taxable income, and stated that a per se rule of taxation for the activity of carrying commercial advertising would have been a significant departure from the prevailing view. The Court also viewed the legislative history as "inconclusive" and concluded with the following:

> "We agree, therefore, with both the Claims Court and the Court of Appeals in their tacit rejection of the Government's argument that the Treasury and Congress intended to establish a per se rule requiring the taxation of income from all commercial advertisements of all tax-exempt journals without a specific analysis of the circumstances."

Having rejected the Government's per se rule contention, the Court then considered whether, in this particular case, the sale of advertising is "substantially related" or "contributes importantly" to the organization's exempt purpose or function. The Court reviewed the arguments advanced by both sides and stated that the Claims Court was correct in scrutinizing the organization's conduct rather than the educational quality of the advertisements. The Claims Court was thought to have properly focused on the organization's conduct of its advertising business, and the Claims Court's treatment of the facts was deemed to be adequately supported

by the record. The following portion of the Claims Court's opinion revealed a number of pertinent facts:

> "The evidence is clear that plaintiff did not use the advertising to provide its readers a comprehensive or systematic presentation of any aspects of the goods or services publicized. Those companies willing to pay for advertising space got it; others did not. Moreover, some of the advertising was for established drugs or devices and was repeated from one month to another, undermining the suggestion that the advertising was principally designed to alert readers of recent developments (citing, as examples, ads for Valium, Insulin, and Maalox). Some ads even concerned matters that had no conceivable relationship to the College's tax-exempt purposes."

On this basis, the Supreme Court concluded that the advertising in the organization's journal does not contribute importantly to its educational purposes. The Court also stated that the Court of Appeals erroneously focused exclusively upon the information that is invariably conveyed by commercial advertising and failed to give effect to the Code and regulations. The Court left open the possibility of the organization's advertising being considered substantially related to its exempt purpose when it stated the following:

> "This is not to say that the College could not control its publication of advertisements in such a way as to reflect an intention to contribute importantly to its educational functions. By coordinating the content of the advertisements with the editorial content of the issue, or by publishing only advertisements reflecting new developments in the pharmaceutical market, for example, perhaps the College could satisfy the stringent standards erected by Congress and the Treasury."

E. Postscript

The impact of the Supreme Court decision in United States v. American College of Physicians should not be underestimated. This is a very important decision with respect to exempt organizations' advertising income. It is safe to say that if the Court of Appeals decision had not been overturned, the area of advertising income would have been in a state of flux. The Supreme Court decision permits the Service to resume "business as usual" as far as subjecting advertising income to the tax on unrelated trade or business. This return to normalcy is accompanied by a heightened awareness of the importance of the "substantially

related" tests under IRC 513 in all cases of unrelated business taxable income, including advertising income. Although the Supreme Court rejected a per se rule that all advertising income is subject to tax, it is believed that applying the Court's facts and circumstances test will result in continued adverse decisions in the vast majority of cases involving this issue.

Any case in which it is believed that advertising income is substantially related to an organization's exempt purpose or function should be referred to the National Office for technical advice. See All ARC memo dated September 15, 1986.

Like the decision in United States v. American Bar Endowment, United States v. American College of Physicians will become a very important precedent in unrelated business income cases. Although the opinion was only announced earlier this year, lower courts are already citing this case in their opinions. As this article was being prepared, the Tax Court cited United States v. American College of Physicians in a case involving advertising income. In Fraternal Order of Police, Illinois State Troopers Lodge No. 41 v. Commissioner, 87 T.C. No. 45 (Sept. 29, 1986), the Tax Court held that advertising income received by an organization exempt under IRC 501(c)(8) was subject to tax on unrelated business income. The advertising was published in a magazine called "The Trooper," which contained articles relating primarily to the duties of police officers. "The Trooper" also contained business listings covering a wide range of professional, consumer, and leisure products and services. The Court held that the publishing of advertising is unrelated trade or business under IRC 513 and also that amounts derived from such activity were not excluded as royalties under IRC 512(b)(2).

4. Cleveland Athletic Club and The Brook

A. Background

The Tax Reform Act of 1969 extended the unrelated business income tax to social clubs exempt under IRC 501(c)(7). Special rules are contained in IRC 512(a)(3), which subjects all the income of an exempt social club to the tax on unrelated business income, except for exempt function income. With respect to a social club, exempt function income includes dues, fees, or similar membership charges for club services or facilities and set-asides for charitable purposes. Specifically, IRC 512(a)(3) provides, in pertinent part, that the unrelated business taxable income of an organization described in IRC 501(c)(7) means the gross income (excluding any exempt function income), less the deductions allowed by

IRC Chapter 1 that are directly connected with the production of the gross income (excluding exempt function income), both computed with certain modifications under IRC 512(b). Thus, under IRC 512(a)(3), an exempt club would generally pay tax on its investment income unless it is set aside for charitable purposes.

B. Rev. Rul. 81-69

This revenue ruling was extensively discussed in both the 1984 CPE text beginning at page 123 and the 1985 CPE text beginning at page 44.

Rev. Rul. 81-69, 1981-1 C.B. 351, discusses a social club, exempt under IRC 501(c)(7), that has unrelated business taxable income from investments made for profit. The club also sells food and beverages to nonmembers at prices insufficient to recover the costs of such sales. Sales of food and beverages to nonmembers have consistently over a number of years resulted only in losses, which are expected to continue. Applying IRC 512(a)(3)(A), the Rev. Rul. holds that because the club's sales of food and beverages to nonmembers are not profit motivated, the club may not deduct losses from sales to nonmembers from its net investment income.

C. Cleveland Athletic Club

This organization (The Club) operates in the same manner as the organization described in Rev. Rul. 81-69. The Club is exempt under IRC 501(c)(7) and derives unrelated business income from two sources - investments and sales of food and beverages to nonmembers. Gross nonmember sales receipts exceeded the direct expenses or cost of sales attributable thereto. However, during the four years in question when indirect expenses were allocated, sales to nonmembers resulted in a net loss. This loss was subtracted from the Club's net investment income to arrive at unrelated business taxable income. The Service, in part, disallowed these losses on the theory that the Club did not have a profit motive with respect to its sales of food and beverages to nonmembers, and that the deductions attributable to sales of food and beverages could only be allowed to the extent they did not exceed gross income from food and beverage sales.

In Cleveland Athletic Club v. United States, 588 F. Supp. 1305 (N. D. Ohio 1984), the Court agreed with the Service's position and held that the Club could not deduct its losses from sales of food and beverages to nonmembers from its net investment income for purposes of the tax on unrelated business income. The Court noted that the Club's primary objective in selling food and beverages to

nonmembers was not to make a profit, and that although the sales activity was run in an efficient manner and in an attempt to maximize economic gain, the main objective of the food and beverage business was to defer some of the fixed or overhead costs which otherwise would have to have been paid by the Club's members.

The Club appealed the District Court's decision, and in Cleveland Athletic Club v. United States, 779 F.2d 1160 (6th Cir. 1985) the Court of Appeals reversed the District Court's decision. The Court of Appeals held that the District Court improperly interpreted IRC 512(a)(3)(A), and that the Club may net the excess expenses attributable to sales of food and beverages to nonmembers against its income from investments. The Court's opinion is based on an interpretation of IRC 512(a)(3)(A) whereby deductions need not necessarily come within IRC 162 as a trade or business, but are allowable as ordinary and necessary to the production of income with a basic purpose of economic gain. The Court stated that the Club's nonmember business activity need not generate a tax profit, and that the nonmember activities were not carried on as a hobby rather than as a trade or business. The Court also invalidated Rev. Rul. 81-69, which it characterized as being an improper interpretation of IRC 512(a)(3)(A), and hence, without legal force and effect.

Although the Service disagreed with the Court of Appeals decision, it was felt that there was no basis to establish a case for administrative importance warranting Supreme Court review. At the time that the decision was being made as to pursuing an appeal, this was the only Circuit Court opinion on this issue and, therefore, no conflict between circuits existed. That would soon change.

D. The Brook

Another social club operating in a manner similar to the organization described in Rev. Rul. 81-69 and the Cleveland Athletic Club is The Brook. This organization is exempt under IRC 501(c)(7) and thus is subject to the tax on unrelated business income in accordance with the requirements of IRC 512(a)(3)(A). During the two years in question, The Brook had two sources of nonmember income: investments and food and beverages sold to nonmembers at private dinner parties hosted by club members. During these years, The Brook had substantial investment income, but avoided paying any tax on this income by deducting losses incurred from the private dinner parties. The Brook incurred losses for tax purposes from the sale of food and beverages to nonmembers for every year between 1972 and 1983. The Brook conceded that it did not intend to

make a profit from selling food and beverages to nonmembers. In its words, it "did not sell food and beverages to nonmembers with an intention that revenues from such sales would exceed all costs relating to such sales including overhead." The Service held that The Brook could deduct expenses incurred with respect to sales of food and beverages to nonmembers only up to the amount of income received from that activity. This position was based on the fact that since The Brook had not intended to make a profit from the sales of food and beverages to nonmembers, the deductions were not allowable under IRC 162.

The Brook brought action in the Tax Court and in The Brook, Inc. v. Commissioner, 50 T.C.M. 959 (1985), the Court decided in the Government's favor, but on a theory that had not been previously advocated. The Court found that IRC 512(a)(3)(A) required that there be a nexus between an expense and the income it was used to offset. Since there was no nexus between the food expenses and the investment income, the Court disallowed the deduction. Since the Government disagreed with the reasoning and The Brook with the result, both sought reconsideration of this decision. Nevertheless, the Tax Court affirmed its holding. The Brook then appealed.

In The Brook, Inc. v. Commissioner, 799 F.2d 833, 58 AFTR 2d 86-5628 (2nd Cir. 1986), the Court of Appeals upheld the Service position and ruled against the organization. Although affirming the Tax Court's result, the Court of Appeals rejected the Tax Court's reasoning, stating that the plain language and legislative history of IRC 512(a)(3)(A) do not support the Tax Court's interpretation of the law. Having rejected the Tax Court's reasoning, the Court of Appeals focused on whether The Brook had established that it could deduct losses suffered from serving drinks and meals to nonmembers from its investment income pursuant to IRC 162. In analyzing this question, the Court of Appeals stated the following:

> "The Brook had stipulated that it had no such profit motive when it engaged in the unrelated activity of selling meals to nonmembers. Accordingly, since the plain language of Section 512(a)(3)(A) requires that a social club may only deduct an expense if Chapter 1 authorizes that deduction, The Brook improperly used its losses from serving meals to nonmembers to write-off a portion of its gross income from its investment activity."

The Court of Appeals for the Second Circuit devoted a good portion of its opinion to addressing The Brook's arguments, which were, in part, derived from

the holding of the Court of Appeals for the Sixth Circuit in Cleveland Athletic Club v. United States, supra. All of these arguments were rejected.

E. Postscript

As a result of the recent court cases, a conflict between the circuits now exists on the question of whether a social club, exempt under IRC 501(c)(7), may deduct losses derived from sales of food and beverages to nonmembers from its net investment income. The Sixth Circuit says "yes"; the Second Circuit says "no". The Sixth Circuit says Rev. Rul. 81-69 is invalid; the Second Circuit's decision essentially follows the holding of the Rev. Rul.

As noted previously, at the time the decision was being made whether to appeal Cleveland Athletic Club, no conflict between the circuits existed. Thus, an appeal to the Supreme Court was not attempted. At the time this article was being prepared, it was uncertain as to whether The Brook, Inc., would be appealed. Even if The Brook does not reach the Supreme Court, it is possible that other cases will emerge, possibly in other circuits, and one of these cases may serve as a vehicle for Supreme Court consideration.

At this time the Service position, as expressed in Rev. Rul. 81-69, should be applied in all cases including cases arising in the Sixth Circuit.

5. Congressional Hearings on Unrelated Business Taxable Income

On September 9, 1986, the Chairman of the House Ways and Means Committee, Dan Rostenkowski, announced that he has requested the Chairman of the Oversight Subcommittee, J. J. Pickle, to conduct a comprehensive review of the federal tax treatment of commercial and other income producing activities of exempt organizations.

Congressman Rostenkowski stated the following:

> "The unrelated business income tax was enacted in 1950, and revised and expanded in the Tax Reform Act of 1969. With limited exceptions, there has been no comprehensive review of the unrelated business income tax rules since 1969. Since that time, there has been substantial growth in the tax-exempt sector of our economy. As of the end of 1985, the IRS Exempt Organization Master File listed approximately 850,000 tax-exempt organizations with total revenues

exceeding $300 billion a year. In recent years, exempt organizations have become more aggressive in undertaking commercial or entrepreneurial activities. For-profit businesses have complained that tax-exempt organizations are provided an unfair competitive advantage under present tax law. Indeed, this issue of unfair competition now has reached national prominence as demonstrated by the designation of this issue as a priority item during the recent National White House Conference on Small Business."

In light of these developments and concerns, Congressman Rostenkowski asked the Oversight Subcommittee to examine the policy considerations underlying the appropriate tax treatment of income-producing activities of tax-exempt organizations, the impact of present law rules on both tax-exempt organizations and for-profit businesses, as well as the Service's application of, and taxpayer compliance with, the law. The Subcommittee will determine whether the current rules set forth the appropriate standards for determining the taxability of the income-producing activities of tax-exempt organizations, and the effect of such activities on tax-exempt status.

The following questions set forth the Subcommittee's framework for review:

A. Profile of Tax-Exempt Organization Activities

(1) What types of income-producing activities--whether considered "active" or "passive"--are carried on by tax-exempt organizations, and how such revenue is produced by such activities? Do different types of tax-exempt organizations tend to engage in different types of investment, commercial, or entrepreneurial activities?

(2) How and why have the type, nature, and extent of such income-producing activities changed since 1950? What are the future trends?

(3) Are tax-exempt organizations and for-profit businesses competing in the same income-producing activities?

(a) To what extent do tax-exempt organizations engage in income-producing activities that are being, or could be carried on, by taxable businesses?

(b) To what extent do taxable businesses engage in income-producing activities that traditionally have been performed by tax-exempt organizations?

(c) Has renewed concern about competition between tax-exempt and for-profit organizations arisen because tax-exempt organizations are moving into innovative revenue-raising techniques or because traditional tax-exempt organization activities have recently become profitable?

(4) To what extent are tax-exempt organizations engaging in commercial activities with for-profit businesses through joint ventures, limited partnerships, or other means? Is the participation of tax-exempt organizations in such commercial ventures inconsistent with their exempt status?

(5) To what extent, if any, do current income-producing activities of exempt organizations relate to Federal budget cuts or other government policies?

B. The Purpose of the Law and its Administration by the Internal Revenue Service and the Courts.

(1) What purposes do the unrelated business income tax rules serve? Are these goals being met?

(2) Are the "relatedness" and "trade or business" tests appropriate and administrable? What is the relationship between the extent of an organization's related or unrelated trade or business activities and its eligibility for exempt status?

(3) What rationales underlie the various exceptions and modifications which permit tax-exempt organizations to engage in certain income-producing activities without taxation? For example, should endowment income be exempt from tax?

(4) How is the law relating to unrelated business income being interpreted? Has interpretation of the law changed over time?

(5) How does the Internal Revenue Service determine whether a tax-exempt organization's activity generates unrelated business income?

(6) Are the current rules unduly burdensome or unreasonably restrictive for tax-exempt organizations?

(7) Do the present-law rules permit unfair competition by exempt organizations? If so, how should the rules be changed?

C. Compliance with the Unrelated Business Income Tax:

(1) Does the Internal Revenue Service have an adequate, well-balanced enforcement program in this area?

(2) What portion of income subject to the unrelated business income tax is reported by recipient organizations on Form 990-T?

(3) Can tax-exempt organizations that do not report or mischaracterize unrelated business income be readily identified?

(4) Are the Forms 990 and 990-T adequate to identify the type of income-producing activity, the degree of "relatedness" of an activity to an organization's tax-exempt purpose, and other compliance issues?

Further details and specific dates for hearings will be announced at a later date.

6. Conclusion

Supreme Court decisions, on-going litigation, and possible Congressional hearings are indicative of the fact that the area of unrelated business taxable income has assumed a high profile. Without question, the Supreme Court decisions will be discussed and applied in many future cases. There seems to be no limit to the types of business activities undertaken by exempt organizations, nor does there appear to be an end to the litigation that inevitably ensues when the Service applies the law in a manner adverse to exempt organizations. It will be interesting to see what direction the Congressional hearings will take, particularly in light of constituents' cries of "unfair competition" reverberating in Congressional ears. Given this renewed attention on the part of Congress, a complete or partial

overhaul of this area is not out of the question. Undoubtedly, next year's CPE text will report on what action, if any, Congress has taken.

As previously mentioned in this article, any case in which it is believed that advertising income is substantially related to an organization's exempt purpose or function should be referred to the National Office for technical advice, and, with regard to deductions of losses from sales to nonmembers by social clubs, the position expressed in Rev. Rul. 81-69 should be applied in all cases.